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SUBJECT: CZECH GOVERNMENT WINS FIRST LEGISLATIVE TEST IN PASSING REFORM PACKAGE

Ref: A. Prague 939
¶B. Prague 698
¶C. Prague 359

¶1. (SBU) Summary: On August 21, the Czech lower chamber approved the government's public finance reforms, securing the first serious legislative victory for the Topolanek government. Despite protracted behind-the-scenes lobbying among coalition partners, one coalition MP defected and voted against the controversial bill. Starting next year, the legislation will gradually reduce corporate and personal income taxes, cut social spending and introduce fees for health care. The bill still requires Senate approval and President Vaclav Klaus's signature, but no resistance is expected from either. However, debate over economic reform will continue with the 2008 budget bill and additional reform legislation next year. End Summary.

¶2. (U) Of the 200 deputies, 101 backed the reform package (99 of the 100 coalition MPs and former Social Democrats Milos Melcak and Michal Pohanka, now unaffiliated). Ludvik Hovorka (Christian Democrat) was the only coalition deputy to vote against the proposal; Hovorka, who is one of the most left-leaning of the Christian Democrats, found the reforms too harsh. All 98 opposition Social Democrat (CSSD) and Communist deputies voted against. The opposition refused to back the proposal, saying the reforms would not curb the deficit as the government claims, and they would harm most people economically. CSSD leader Jiri Paroubek said his party would revise the economic reforms once it returns to power.

¶3. (SBU) The tight vote in the lower chamber was preceded by two weeks of exhausting coalition negotiations. Although the draft reform bill passed in the first reading with the votes of all coalition MPs, several of them threatened later that they would not support the bill in the final reading unless their changes were incorporated during the second reading. The most vociferous voices were Hovorka and former Finance Minister Vlastimil Tlusty (ODS). Unlike Hovorka and the opposition, Tlusty and a few other ODS MPs criticized the government reform bill for not going far enough in reducing tax rates. Tlusty and the other ODS MPs voted for the reform after they won agreement to lower tax rates below the original government proposal. But after the bill passed its second reading in mid-August, Tlusty and his supporters discovered further concerns in terms of tax deductions they did not like; they secured a promise from PM Topolanek that the government would propose revisions to remedy these next year. On the other hand, Hovorka did not accept any compromise solutions offered to him by coalition negotiators and eventually voted against the reform bill. While the tensions with Tlusty and Hovorka did not prevent passage of the bill that Topolanek had at one point said he would stake the fate of the government on, the difficulty in winning passage, and particularly the failure to bring Hovorka on board, suggests the government could face further problems in parliament. On the other hand, the two CSSD "renegades" proved their reliability on this vote.

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¶4. (U) Despite the fact that the fiscal problems preventing early Czech Republic Euro adoption (target date postponed from 2009 until 2012) are based on the expenditures side (general social benefits), most of the public debate over the reform bill has been focused on the income side (tax cuts, which have long been an ODS priority). Personal income tax rates will be cut to a flat rate of 15% for all income levels in 2008 and to 12.5% in 2009, corporate tax will be cut to 21% in 2008 and to 19% in 2009 from the current 24%, and the lower of the two VAT brackets for "basic goods" will be increased from 5% to 9% while the second VAT rate for "luxury goods" will remain at 19%.

¶5. (U) There is strong consensus among economists that something must be done about public finances and that while this reform package is better than nothing, it can hardly be considered "radical" reforms. Instead of using increased revenues from changes to the VAT rate to finance the deficit, the government will use it to offset the income and corporate tax cuts. Private sector economists predict the reform package will yield a general government deficit of 4.5%/GDP. (Note: Maastrich convergence criteria = 3%/GDP. End Note) While economists lament the continued lack of fiscal discipline, the business sector is thrilled by the corporate tax cuts that will put the Czech Republic on par with neighboring Slovakia's corporate tax regime.

¶6. (U) On the expenditures side, effective 2008, there will be a cap on social taxes at USD 4,000/month, the retirement age will increase to 65, birth allowances will be reduced, maternity allowances will decrease after two years, the parental allowance will be limited to lower income brackets, benefits for parents with children entering the first grade will be abolished, and for the first time, people will pay a nominal fee for doctor's visits. Effective 2009, the first three days of sick leave will not be paid at all and sickness

benefits will increase after the 30th day to help individuals with long-term care issues. This is to address the fact that he Czech Republic currently has one of the highest number of sick leave days taken among EU countries.

¶7. (SBU) Comment: Debate over public finance reform will continue as the 2008 budget is expected to be presented to Parliament in September, and looming down the road are a pension reform bill by the end of 2007 and a health care reform bill in 2008. In addition, to appease ODS Deputy Chair Vlastimil Tlusty, who has been a relentless thorn at PM Topolanek's side, the government agreed to amend the reform package within six months. However, current Christian Democrat Finance Minister Kalousek, even after voting in favor of the reform package that cuts personal income tax to a flat rate of 12.5% in 2009, has said publicly that he does not believe the income tax rate should be lower than 15% due to budgetary implications. Given this kind of internal battles within the ruling coalition, we can expect further drama in Parliament in the near future.
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